Guide to **Split Dollar**

ADVANCED PLANNING CONCEPT

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Why Split Dollar?

A business owner wants to buy permanent life insurance.

- Maybe it's for their personal use as they want to provide a death benefit to ensure a legacy for their family or to offset the cost of estate taxes.
- Maybe, in addition to the death benefit, they want access to the benefits the policy may offer through riders and the potential cash value growth.[1]
- Perhaps they want the insurance for business purposes, such as funding a buy-sell agreement.
- Finally, they may want to provide a vital benefit to the key employees of the business.

In any of these situations, the business owner may want a technique where:

- The life insurance is paid for with business dollars.
- The business will recover the cost of providing life insurance.
- There is a minimal personal out-of-pocket cost to the executive/participant.

These may all be possible when a split dollar arrangement is used.

What is Split Dollar?

Split Dollar is a way for two parties to share the costs and benefits of a permanent life insurance policy.

The concept has been around for a long time, with IRS rulings going back to the 1950s.[2] The idea was (and to a great extent continues to be) fairly straightforward: Let the business and the Executive split the costs and benefits of a permanent life policy. (It is possible to use split dollar in a non-business setting. We will review private split dollar in a separate guide.)

Think of "split dollar" as an umbrella term that actually covers two different concepts (the IRS calls them "regimes").

The regimes are:

Split Dollar Economic Benefit

The Executive will receive income tax-free death benefit protection. The policy that funds the death benefit for the Executive will also provide death benefit protection and, potentially, cash value growth to the business. The business will control the policy.

Split Dollar Loan

The Executive will receive income tax-free death benefit protection as well as all the other benefits of a permanent life insurance policy. The business will generally receive a return of the amounts it provides as loans under the arrangement and may also receive interest due on those loans. The Executive will own and control the policy.

Because the tax results, benefits, and cash flow are so different between the two tax regimes, we will address each separately. Also, please be aware that split dollar taxation was radically changed in 2002 and 2003. This review only considers split dollar arrangements entered into or materially modified after September 17, 2003.

To some extent, both strategies rely on the cash value accumulation in the policy. Please be aware that the ability of a life insurance contract to accumulate sufficient cash value to meet illustrated accumulation goals will be dependent upon the performance of the contract and is not guaranteed.

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1 Accessing the policy's cash value through the use of policy loans and withdrawals will reduce the policy's cash value and death benefit and may result in a taxable event. Withdrawals, up to the basis paid into the contract and loan thereafter, will not create an immediate taxable event, but substantial tax ramifications could result upon contract lapse or surrender. Surrender charges may reduce the policy's cash value in the early years.

2 See Rev. Rul. 55-713 which was revoked by Rev. Rul. 64-328

Split Dollar Economic Benefit Regime

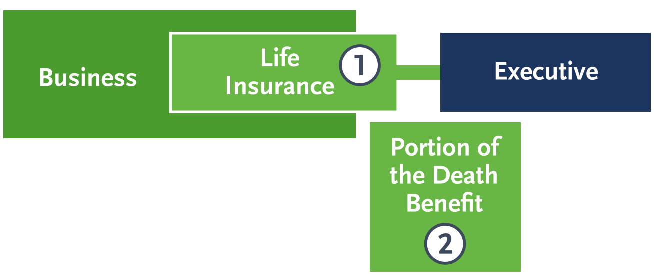
This arrangement combines death benefit protection for the participant's family and key person life insurance benefits for the business.

Take a look at this graphic. It shows you the basics of the cash flow under a Split Dollar Economic Benefit Regime arrangement.

1. The business is the deemed[3] owner of the life policy. The business controls (by ownership or assignment) all elements of the policy, including the cash value and policy riders.
2. The death benefit will be split between the business and the executive.

The family will receive the death benefit income tax-free.

This is called a non-equity arrangement because the executive will not be given rights to policy cash values. Cash value is owned and controlled by the business.



What are the benefits to the executive?

The executive will name the beneficiary on the portion of the death benefit provided to him/her under the arrangement. The executive's beneficiary will receive the death benefit, generally income tax-free.[4] The cost to the executive is generally, relatively low.

The Executive's actual out-of-pocket cost is the tax due on the term value of the death benefit. Please see the section on tax consequences and cash flow to the executive for a more comprehensive review of these values.

What are the benefits to the business?

The business controls (by ownership or assignment) the permanent life policy on the life of the executive. The policy is an asset on the business's balance sheet.

During the term of the arrangement, the death benefit from the policy is split between the business and the executive's named beneficiary. The death benefit, when paid to the business, will be received income tax-free as long as the requirements of IRC Section 101(j) are met (more details on this later).

The policy may serve multiple business needs including:

- Enhancing the employee's benefit package, allowing for better retention and recruitment;
- Providing the business with a valuable asset on the balance sheet;
- Providing the business with key person protection/ informal funding for other non-qualified benefit arrangements.

What is the tax result/cash flow to the executive?

The amount included in the executive's gross income, called the economic benefit, is the term insurance value of the death benefit provided to the executive beneficiary. Think of it this way; the executive is provided with a death benefit and must include in gross income the value of that death benefit protection.

As long as the split dollar arrangement is in place the economic benefit is taxable and is reported annually.

Please note: It is possible to have an economic benefit split dollar arrangement that provides equity to the insured in the form of rights to some or all of the policy cash value. Tax consequence of this type of arrangement includes a current tax on increases in the cash value available to the insured as well as the economic benefit.

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3 What is deemed ownership? It is possible to have the business treated as the owner even where the insured (or third party) is the actual policy owner. For instance, if the policy is owned by the insured and collaterally assigned to the business — with the business having the right to recover the greater of its premiums paid or the cash value — then the business will be treated as the deemed owner and the arrangement will receive economic benefit treatment.

4 IRC Section 101(a) provides for the income tax-free receipt of life insurance death benefits. Please be aware that exceptions may apply including Transfer for Value and IRC Section 101(j) requirements.

The executive pays the tax on the value of the death benefit provided. This is called the economic benefit.

How to calculate the amount included in income: non-equity split dollar.

To determine the economic benefit under the arrangement you need to have the following information:

- The death benefit split — what is payable to the employee's beneficiary and what is payable to the business.
- The term insurance rate at the insured's attained age. There are two resources allowed by the regulations:
  - Table 2001 (term rates provided by Treasury)
  - The issuing insurance company's published rates for individual, initial issue, one-year term policies are available to all standard risks.
- The costs paid by the employer for certain policy riders that may benefit the employee. (This includes waiver of premium riders. Also, if dividends are used to increase benefits to the employee, then the value of the dividends must also be included in income.)

The basic calculation.

1. Take the total death benefit available during the current tax year.
2. Subtract the amount that is paid to the business pursuant to the arrangement.
3. Divide the sum by 1,000.
4. Take the term rate per thousand for the client's attained age. The taxpayer may use either the IRS Table 2001 rate or a term rate that meets the IRS's guidelines.
5. Multiply the term rate by the result in step 3.
6. Add the premium paid on riders (such as waiver of premium) and any dividend that should be included.
7. Subtract any contributions the employee made to the premium.

Where the policy is a second-to-die policy, the Table 2001 rate is adjusted to reflect two lives. That adjusted rate is used as long as both insured's are alive. This is often referred to as the Table 38 costs. After the first death the rate will go to the single life rates.

OK — let's look at an example — first, the sample facts.

Policy Death Benefit	$2,000,000
Policy Cash Value	$400,000
Total Employer Premium Payments	$200,000
Waiver of Premium Rider	$325
Employee contribution	$0

The agreement provides that the employer's interest in the death benefit is equal to the greater of its premium payments or the cash value. Let's assume that the term rate at the insured's attained age for this year is $1.53 per thousand (based on the Table 2001 rates).

Let's look at the math.

Step 1: $2,000,000 – $400,000 = $1,600,000 (Total death benefit — greater of cash value or premium paid).

Step 2: $1,600,000/$1,000 = $1,600 (the per thousand adjustment).

Step 3: $1,600 x $1.53 = $2,448 (this is the basic economic benefit under the arrangement).

Step 4: $2,448 + $325 = $2,773 (this is the adjustment for the waiver of premium rider).

Step 5: $2,773 – 0 = $2,773 (this is the final adjustment that will account for employee contributions).

As you can see, the amount included in the executive's gross income is $2,773. The out-of-pocket cost for the benefit is the tax due on the $2,773. For instance, in a 25% bracket, the executive's out-of-pocket cost in that year is $693.25.

What is the tax result to the business?

The business, as the owner and premium payer of the life insurance, will pay the premium with after-tax dollars.

- The premium paid is not a deductible expense to the business.
- The economic benefit included in the employee's gross income is not a deductible expense to the business.

Generally, the death benefit will be received by the business on an income tax-free basis.

Because these are business owned life insurance policies, to preserve the income tax-free treatment of the death benefit under IRC Section 101(a), the parties must meet the Notice and Consent requirements spelled out under IRC Section 101(j). The business must notify the proposed insured, in writing, of the following:

1. Life insurance on that individual's life will be applied for by the business;
2. The maximum face amount at the time of issuance, and
3. A statement that the business will be the beneficiary of the death benefit.

The proposed insured must consent to the purchase in writing. The consent must state that the insured is aware that the business may keep the policy even after the insured has left the business. And yes, this requirement applies even where the insured is an owner of the business.

This notice and consent requirement must be completed BEFORE the policy is issued. If the notice and consent is not obtained before the policy is issued, the death benefit, when paid, will be treated as ordinary income to the business.

With the notice and consent in place, death benefits may be received income tax-free if one of these other conditions are met.

Exceptions based on the insured's status:

1. Insured was an employee at any time during the 12 month period before the inured's death, or
2. Is, at the time the contract is issued, a
   a. Director, or
   b. Highly compensated employee within the meaning of Section 414(q), or
   c. An individual who was one of the highest paid 35%, or
   d. One of the top 5 highest paid officers, or
   e. The insured owns more than 5% of the business, or
   f. The insured was a shareholder who owned more than 10% of the stock.

Exceptions for amounts paid to the insured's heirs:

1. Death benefit is paid to a member of the family, or
2. Death benefit is paid to a trust established for the benefit of the family, or
3. Death benefit is paid to the insured's estate, or
4. Death benefit is paid to the insured's named beneficiary, or
5. Death benefit is used to an interest in the business.

Please use National Life Group's Employer Owned Life Insurance Contract Insured Notification and Consent form — Cat #50258.

Please note, National Life Group will not issue the policy until a Notice and Consent form is filed with the company.

How do you establish this arrangement?

There are two ways to set up a split dollar benefit regime arrangement.

Endorsement

1. The business will purchase a permanent life insurance policy on the life of the key person. The business will endorse a portion of the death benefit to the Executive's named beneficiary. The Executive will have no ownership interest in or control over the life insurance policy itself.
2. There must be a written agreement between the parties spelling out the terms of the arrangement and the business should include the decision to create the arrangement in its corporate minutes.
3. The business must obtain a notice and consent from the insured and have that in place before the policy is issued. Failure to obtain the notice and consent could cause the death benefit payable to the business to be treated as ordinary income under IRC Section 101(j).
4. If the terms of the arrangement are carefully spelled out, the requirements under IRC Section 409A may be limited.

Collateral Assignment

1. The insured will purchase a permanent life insurance policy.
2. There must be a written agreement between the parties spelling out the terms of the arrangement and the business should include the decision to create the arrangement in its corporate minutes.
3. The business will pay the premium on the policy and will secure an interest in the policy via a collateral assignment from the policy owner.
4. The business will receive the right to all of the cash value in the policy and a death benefit generally equal to the greater of the business' premium payments or cash value.
5. The insured's named beneficiary will receive the remainder of the death benefit. The requirements under 101(j) should also be followed along with any 409A requirements that may be applicable.

Putting this all together — Where will this make sense to use?

OK — you've gone through all the details. You have a sense of how the money flows, where the benefits go, and what the tax results may be. But where and when would a split dollar economic benefit arrangement make sense to offer?

Consider the following situations:

1. A business wants to provide certain employees with an additional benefit but wants to maintain control of the life insurance for key person and benefit cost recovery purposes.
2. A business has a wait and see buy sell agreement. The business will have access to the cash values and a portion of the death benefit to assist with business cash flow issues but the bulk of the death benefit will be received by the co-owners to help them complete the cross purchase part of the agreement.

Let's go into detail on one of these situations.

Providing a Benefit to a Key Employee

As part of ABC, LLC's benefit program the business decides to offer Ms. Kelley Key a benefit that will deliver income tax-free cash to her family in the event of her death. Also, the business wants to acquire life insurance protection to cushion the impact on the business of Kelley's death. They will use these funds to help cover potential losses and the cost of finding and recruiting her replacement.

By using an economic benefit split dollar arrangement, the business can cover both requirements with one policy.

1. ABC, LLC applies for a permanent life insurance policy on Kelley's life with a death benefit of $1,000,000.
2. When the application is taken a notice and consent form is supplied to Kelley — which she signs and returns prior to the policy being issued.
3. A written agreement spelling out the terms of the agreement is entered into between Kelley and ABC, LLC.
4. ABC, LLC is the owner of the policy. The policy is issued and Kelley names the beneficiary of her portion of the death benefit, generally through an endorsement on the policy. In this case they set an amount of $500,000.

Please note, the designs for this plan are almost limitless. Another common design is to define the employee's death benefit by formula. For instance, the formula may provide that the business receive an amount equal to the greater of its premium payments or cash value, the employee's beneficiary will receive the rest.

5. Kelley's out-of-pocket cost is the tax due on the economic benefit. The calculation in this example is fairly straightforward — take the Table 2001 cost (or the issuing company's term insurance rate) at Kelley's attained age and multiply that number by the death benefit payable to Kelley's beneficiary.
   a. Let's say Kelley is 45. The Table 2001 rate is $1.53 per thousand.
      i. $500,000 / $1,000 = 500
      i. 500 x 1.53 = $765

So, $765 is included in Kelley's gross income for the year. If Kelley is in a 25% tax bracket, her out-of-pocket cost for the $500,000 of life insurance protection is only $191.25.

6. As Kelley gets older, the cost will increase as the term rates will go up each year.

Split Dollar Loan Arrangements

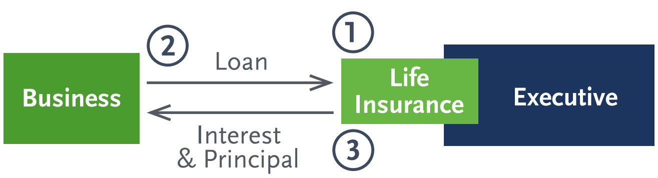
Other than sharing the term "Split Dollar" in its name, a split dollar loan arrangement is completely different than the economic benefit split dollar arrangement.

Generally, a split dollar loan arrangement provides:

- The executive with ownership of a permanent life insurance policy
  - Income tax-free death benefit protection for their family;
  - Permanent life insurance policy benefits from riders and potential cash value growth (in excess of the business' interest in the policy).
- The executive with a relatively low out-of-pocket cost;
- The business with a return of its payments made to the arrangement;
- A valuable retention and recruitment tool.

See the graphic below. It shows you the basics of the cash flow and ownership structure under this arrangement.

1. The employee will own the policy.
2. The business will pay for all or a portion of the premium via a loan.
3. The agreement will be memorialized in writing and there will be a collateral assignment of the policy back to the business.



What are the benefits to the executive?

- The Executive will own and control a permanent life insurance policy.
- Through the policy, the executive's family will receive death benefit protection which they will receive income tax-free.[5]
- In addition, cash value, in excess of the business' interest in the policy, belongs to the executive for future use.
- Following the repayment of the split dollar loan to the business, the executive will be able to use all of the policy benefits including cash value for supplemental income, accelerated benefits,[6] collateral for other loans, etc.
- The executive receives all of these benefits at a relatively low personal out-of-pocket cost. That cost (as you'll see in a moment) is either the interest paid on the loan or the tax due on the portion of the interest that is deemed to be a below market loan.

What are the benefits to the business?

- The business will provide a valuable benefit to the key employees and owner/employees in the form of permanent life insurance protection.
- The business will receive an interest in the policy, via a collateral assignment, equal to the total of its loans.

5 Pursuant to IRC Section 101(a), assuming no transfer for value has occurred.

6 Accelerated benefits are provided by riders that are optional, may be available at additional cost, and may not be available in all states or on all products. Payment of Accelerated Benefits will reduce the Cash Value and Death Benefit otherwise payable under the policy. Receipt of Accelerated Benefits may be a taxable event and may affect your eligibility for public assistance programs. Please consult your personal tax advisor to determine the tax status of any benefits paid under this rider and with social service agencies concerning how receipt of such a payment will affect you. Riders are supplemental benefits that can be added to a life insurance policy and are not suitable unless you also have a need for life insurance. This is not a solicitation of any specific insurance policy.

- ✓ If the agreement ends during the insured's life, the business will receive repayment of their loan, generally from the cash value of the policy, if there is sufficient cash value. At that point, the assignment is released. If termination of the agreement occurs during the executive's life, repayment may be made from the funds in the policy, if there is sufficient cash value, or, if the executive prefers, from any other source of personally owned funds.
- ✓ If termination of the agreement occurs due to the death of the executive the repayment is made from the policy death benefits.

How do you establish this arrangement?

The life insurance is personally owned by the executive (this arrangement may also be between the business and a trust created by the insured or established under a buy sell agreement as cross owned insurance).

The business and the policy owner will enter into an agreement in writing, spelling out the terms of the loan arrangement. The parties will also enter into a collateral assignment which will create a security interest in the policy for the business equal to the total of its loans (and unpaid interest, if any) under the arrangement. A collateral assignment should be filed with the insurance company.

The business should note the agreement in its corporate minutes. Prior to the policy being issued it is good practice to obtain a notice and consent from the insured so that the provisions of IRC Section 101(j) will not cause the death benefit, when paid to the business to be treated as taxable income.

What are the terms of the loan?

The loan may be a term note or a demand note (there may be different consequences depending on the type of note — see below). The interest on the loan is usually set, at a minimum, at the federal interest rate applicable for the note used.

Term Notes: For term notes, the applicable federal rate is determined by the term of the term note as follows:

1. 1–3 years — use the short-term rate
2. 3–9 years — use the midterm rate
3. More than 9 years use the long-term rate

Demand Notes: For demand notes, the applicable federal rate is essentially a blended rate announced by Treasury in July of each year. For arrangements using a demand note, the interest rate on the total loan may be adjusted annually as the rate may change each year. Some arrangements will lock in the rate for each note — however, that can result in the note being treated as a below market note in years where the locked in rate falls below the declared rate for the period. If the parties do not want the variability of the demand note, then using a term note will be more appropriate.

Hybrid Loans

It is possible to set the loan repayment to a time frame that does not have a preset number of years and is also not a demand loan. Typically we see these as repayment at termination of employment (i.e. retirement) or death (whichever is sooner). The IRS will treat these as term loans for the purpose of setting the minimum interest and deems the term as based on the insureds mortality, expectations. For all other tax purpose, the loan is treated as a demand loan.

The cash flow and tax results to the executive.

The business will, generally, pay the entire premium on the policy and will treat the payment as a split dollar loan.

Market Rate Loans

The interest rate in the arrangement is set, at a minimum, at the applicable federal rate. There are different results depending
on the party's actions.

1. The interest due on the loan is paid by the executive to the business.
   a. This is not a deductible interest payment by the executive.
   b. Interest on the loan is due annually. Some arrangements allow the executive to accrue the interest payments, rolling them up into the repayment at the termination of the arrangement.
   c. The interest is included in the business' gross income.

2. The executive does not pay the interest that is due (through default or via a waiver by the business). Where interest is not paid the arrangement will be deemed to be a below market note in that year.
   a. The difference between the unpaid interest and the minimum applicable federal rate will be deemed to be compensation to the executive and, the business will still be deemed to be in receipt of the interest payment.
      i. As an example, let's say the interest due using the minimum applicable rate was $1,000. If the participant does not pay the $1,000 that $1,000 will be included in the participant's gross income.
      i. If the participant only paid $750, then $250 would be included in gross income.
   b. The cash flow result for the business is potentially a wash for the business as they will include the interest as income but the compensation to the executive should be deductible.

Below Market Loans

What happens if the interest rate set on the loan is below the applicable federal rate? If the interest rate is set below the applicable federal rate, the arrangement will be deemed to be a below market note and the terms of IRC Section 7872 will apply.

There is a difference in tax results depending upon whether this is a term or demand note.

1. **Term:** The difference between the interest charged and the applicable federal rate will be treated as income to the executive. Where there is a term note, rather than the difference in rates being picked up as income in each year, the value of the taxable income over the entire term of the loan will be charged to the executive in the first year of the term loan. This acceleration in the employee's taxable income is called original issue discount.
2. **Demand:** The difference between the interest charged and the applicable federal rate will be treated as income to the executive. There is no original issue discount issues for demand loans.

What are the cash flow and tax results?

- ✓ The loan payments are not a deductible expense to the executive.
- ✓ When the business receives the interest payment from the policy owner, that interest is taxable income to the business.
- ✓ If the arrangement is a below market loan, the interest that should have been paid to the business will still be treated as having been received by the business. However, because the policy owner will have to include the below market interest as compensation, the business will be able to deduct that amount. This will typically result in a wash for the business.
- ✓ During the period prior to repayment of the loan the business will reflect the note as an asset on its balance sheet.
- ✓ When the loan principal is repaid, the business will not have to include the principal repayment as income.

ERISA implications of split dollar.

Split Dollar arrangements are subject to ERISA and are treated as welfare benefit plans. Where the arrangement is provided to highly compensated employees or a select group of managers, the plan is generally fully or partially exempt from most of ERISA rules (such as reporting and vesting).

Most notably, split dollar arrangements must meet certain fiduciary requirements including;

1. The plan must be in writing.
2. There must be a named fiduciary who will manage the plan.
3. The plan document must describe a claims procedure.

In addition, while no annual reporting is required to the Department of Labor, it is possible for DOL to request a copy of the plan documents. It is good practice to provide the participants with a copy of the signed agreement and other material (such as policy illustrations).

Please be aware that arrangements insuring more than 100 participants may be subject to additional ERISA requirements.

ERISA is a complex law and all plans should be drafted and reviewed by the client's counsel for a review of ERISA implications.

Split dollar and IRC section 409A.

IRC Section 409A was added to the tax code in 2004 pursuant to the American Jobs Creation Act and became effective December 31, 2004. IRS Notice 2007-34 provides guidance on the applicability of Section 409A to split dollar arrangements.

Generally, Section 409A was designed to curb perceived abuses where a business provides non-qualified deferred compensation arrangements to an employee. The provisions of this code section spell out a myriad of rules involving permissible payments or distributions, timing of elections and many others provisions. A non-qualified deferred compensation plan is "any plan that provides for the deferral of compensation, which means that a service provider has a legally binding right during a taxable year to compensation that, pursuant to its terms, is or may be payable to (or on behalf of) the service provider in a later year. Specific exceptions to the requirements under Section 409A include welfare benefit plan and welfare benefits which includes death benefit plans.

Failure to comply with the section results in a fairly onerous tax penalty. Income deferred will be included in current taxable income. There is a 20% excise tax on the amount included in income and interest at the underpayment rate.

IRS Notice 2007-34 provides for the exclusion of certain split dollar arrangements from 409A.

1. Non-equity split dollar arrangements
2. Collateral assignment split dollar arrangements (except if all or a portion of the repayments on the loans are waived, cancelled, or forgiven) are specifically exempt from 409A.

409A is a complex tax provision. All split dollar plans should be reviewed by the client's counsel for an analysis of Section 409A implications.

Putting this all together — Where will this make sense to use?

Now that you've been through the details on split dollar loan arrangements you are probably thinking, "Where does this make sense to use?"

Consider the following situations:

1. The business wants to provide a supplemental retirement and death benefit program to their key employee(s). However, they want to control the benefit for a period of time — making the plan a golden handcuff arrangement. They'd also like to recover some of the costs of the entering into the arrangement.
2. The business owners of a C Corporation want to use business funds, which may be in a lower tax bracket than their personal income, to fund their own supplemental retirement and death benefit program.
3. The business owners of a C Corporation want to use business funds to pay for the cross owned life Insurance that is being put in place to fund a wait and see buy sell.

Conclusion — Split dollar, as a method for splitting the costs and benefits of a permanent life insurance policy may prove beneficial to certain life insurance purchasers. The two different split dollar methods provide different tax costs and cash flow benefits.

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